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Guangdong: Hothouse for Zhao's Reforms [REDACTED]

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Summary

During January, General Secretary Zhao Ziyang called on China's coastal provinces to adopt an export-oriented growth strategy so they could serve as "engines" of growth for backward interior regions. As part of this strategy, Zhao has given Guangdong Province the green light on financial, land use, price, and foreign trade reforms. We believe Zhao hopes Guangdong will not only take the lead in promoting his export strategy, but also serve as a reform showcase for other provinces. [REDACTED]

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Given Guangdong's strong economy, its access to Hong Kong markets and capital, and Zhao's patronage, it should be able to push ahead with these reforms. Other coastal areas will almost certainly try to follow suit, taking their cue from Zhao's call to "learn from Guangdong." The introduction of these policies to more backward provinces is likely to be much slower, however. Zhao will have to guard against the kind of foreign exchange drain and corruption similar trade decentralization

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[redacted]

policies encouraged in 1983-85. For the coastal provinces to act as a catalyst for growth in the interior over the long run, moreover, reformers will have to find more effective ways to break down internal trade barriers. Worried about shortages, for example, Hunan and Jiangxi recently placed embargoes on the sale of pork and other goods to Guangdong. As the coastal areas grow richer, this kind of protectionism could grow worse. [redacted]

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Learning From Guangdong

Asserting that China's comparative advantage in labor costs gives it an historic opportunity to succeed South Korea, Japan, and Taiwan as a leading producer of labor-intensive export manufactures, Zhao recently called on China's coastal provinces to take the lead in pursuing an export-oriented strategy. In the coming year, Zhao hopes Guangdong Province--already China's leading exporter--will serve as a model for the other coastal provinces by implementing an ambitious package of reforms. Indeed, in a recent series of inspection tours, he urged the leaders of Shanghai, Jiangsu, and Fujian to go to Guangdong and learn from its example. [redacted]

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According to Chinese and Hong Kong press sources, Zhao Ziyang presented his plan for further reforms in Guangdong to the new Politburo at its first plenary meeting on 14 November, after receiving the support of Deng Xiaoping. Three days later, Guangdong Governor Ye Xuanping officially informed Guangdong's leaders that Beijing wanted the province to become an "experimental zone for overall reforms"--a hothouse for China's next round of economic restructuring. In return, Beijing promised to grant Guangdong greater freedom in economic decision making. These experiments will include price, management, wage, and foreign investment reforms, as well as a major expansion of Guangdong's export-oriented Pearl River Economic Zone, according to statements by provincial leaders (see list of initiatives in appendix A). [redacted]

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We believe Zhao chose this local hothouse strategy because the Beijing leadership is not ready to proceed nationwide with a new package of economic reforms. The recently announced 1988 reform plan--which shied away from most market-oriented policies--reflects the clear lack of consensus among the top leaders about the direction of reform. Beijing's agenda is also too full with the upcoming restructuring of central party and government organs to tackle a controversial new set of reforms. Finally, the current central government emphasis on price stability is not conducive to radical departures that may exacerbate excess capital construction, deficits, and inflation. For now, Zhao can promote major reforms in the friendly soil of provinces like Guangdong, while waiting for economic and political conditions to improve before pushing them nationwide. [redacted]

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Guangdong's Assets Abound

[redacted] the reform program in Guangdong is far ahead of other provinces'. In several key areas of deregulation--such as price reform, managerial autonomy from official interference, and market allocation of both consumer and producer goods--Guangdong's reformers have been able to implement policies that have stymied their counterparts elsewhere (see below). [redacted]

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As Zhao's proving ground for the next stage of reforms, Guangdong enjoys numerous advantages:

- Guangdong's proximity to Hong Kong has provided a stream of investment capital, family remittances, managerial talent, and manufacturing jobs unmatched in the rest of China. According to official Chinese statistics, 54 percent of all the paid-in direct foreign investment in China since 1979 has gone into Guangdong, most of it from Hong Kong and the overseas Chinese community. Hong Kong manufacturers also see Guangdong as a convenient haven from the crown colony's high land prices and shortage of cheap labor. As one put it, "Hong Kong is the storefront, and (Guangdong's) Pearl River Delta is the factory." Hong Kong electronics industry analysts estimate that Hong Kong-financed electronics firms alone employ between 500,000 and 1 million of Guangdong's 62 million residents. Blessed with this constant supply of capital, jobs, and export markets, Guangdong's reformers face fewer unemployment worries than other provinces as they try to force local enterprises to either produce more efficiently or face closure (for a comparison of the economy in Guangdong and elsewhere, see appendix B).
- The current Guangdong leadership is stable and proreform. It is also extremely well connected, not only to Zhao, but to other Beijing leaders-- many of whose children hold posts in the province. Party Secretary Lin Ruo is the chief heir to Zhao Ziyang's network of "Northern Cadres," who have helped lead Guangdong since 1950. Governor Ye Xuanping--eldest son of the late Politburo Member Ye Jianying--still enjoys great family prestige in both Beijing and his native Guangdong.
- Because the local economy is prosperous--jobs are available, wages higher than elsewhere in China--workers have been able to pay higher prices for consumer goods and foodstuffs. This has encouraged peasants and industries in other provinces to "export" their products to Guangdong in search of higher profits. As a result, Guangdong officials have faced less severe political problems from inflation, goods shortages, and worker discontent than other provinces.

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Guangdong's Reforms: A Strong Base

Though reform in Guangdong has proceeded unevenly, Guangdong was the first province to seize the initiative in "opening up to the outside world," and it remains China's leading reform province. [REDACTED]

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In 1979, with State Council approval, Guangdong opened three of China's four Special Economic Zones (SEZs)--in Shenzhen, Zhuhai, and Shantou. In 1985, Guangdong also granted the Pearl River Delta region special authority to promote foreign investment. By the end of 1986, over 65 percent of all the Sino-foreign and foreign firms in China were in Guangdong. [REDACTED]

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According to State reporting, Guangdong leads most regions in wage and labor reforms. The lifetime employment system, which makes it difficult or impossible for managers to fire unproductive workers, is less widespread in Guangdong than elsewhere. Factories are also freer to adjust worker pay to reward productivity. Temporary labor service companies in the province also help factory managers cut the permanent staff and control labor costs. [REDACTED]

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Price reform has proceeded further in Guangdong than anywhere else in China, not only on foods and consumer goods, but also on producer goods traded between enterprises. According to both State and provincial estimates, over 70 percent of all prices in the province are now "market" prices--although many still float within officially fixed ranges.¹ As a rough benchmark, Zhao's most optimistic statements to date call for 70 percent of China's economy to be market regulated by three years from now. Resourceful local officials have avoided a return to rationing, recently revived in other provinces. Instead, they have developed elaborate systems of subsidies, imports, and compensatory taxes to keep prices market responsive yet within reach of local consumers. [REDACTED]

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Guangdong also has made substantial progress in financial reform. State officers report that most industrial expansion is financed through bank loans--rather than government allocations--and banks insist more strongly on the creditworthiness of potential borrowers. Several Guangdong cities have also established foreign exchange centers, whose exchange rates are close to local market (that is, black-market) prices. [REDACTED]

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¹ The 70 percent figure for price decontrol is measured by gross commodity value, rather than number of goods. [REDACTED]

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- Guangdong's traditional emphasis on collectively or individually owned, small-scale, consumer goods enterprises--whose production is less controlled by Beijing's central line ministries--reduces central interference and leaves Guangdong freer to respond to market shifts. Indeed, only about 17 percent of Guangdong's industrial workers are employed by state-owned enterprises, in contrast to heavy industry - oriented Shanghai or the Northeast, where figures as high as 50 percent are common.
- Guangdong is permitted to keep a higher percentage of its annual revenues than other relatively developed provinces. Guangdong has contracted with Beijing to remit 1 billion yuan per year to the central government (less than one-seventh of total provincial revenues). Shanghai, by comparison, has until recently been forced to remit about 75 percent of its revenues, a much heavier burden.

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But Reform Entails Risks

Despite these advantages, we believe that Guangdong officials will proceed carefully in implementing further reforms. Guangdong's inflation rate, for example, is the highest in China, prompting many delegates to the recent provincial People's Congress to complain publicly that prices for pork, vegetables, and other foods have risen too quickly. Provincial reformers have already worked out elaborate price support schemes, as well as set aside over 400 million yuan in subsidy money, to ease the blow to consumers, according to State reporting.

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Further grants of local autonomy may fuel corruption and create severe, unintended economic problems that require Beijing to reassert control. In late 1984, for example, officials in Guangdong and the SEZs--abusing relaxed foreign trade regulations--depleted foreign exchange reserves by importing large quantities of goods and reselling them illegally for private gain on the domestic market.

many of these resale schemes were thrust upon Guangdong and the SEZs by Beijing ministries and other provincial authorities eager to cash in on the SEZs' special autonomy to make profits for themselves on the lucrative black market. When Beijing conservatives attacked such transgressions, Deng and Zhao were forced to tighten controls on trade and foreign exchange.

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Looking at Guangdong's proposed 1988 reform package (appendix A), we see similar potential for abuse. We expect, for example, that some local officials in the newly expanded Pearl River Economic Zone will take advantage of their new foreign trade and investment autonomy to divert resources to lucrative resale businesses or local pork-barrel projects. We also believe it is likely that officials in other parts of China will again try to enrich themselves by taking advantage of Guangdong's new grant of autonomy. Other provinces might, for example, attempt to establish bogus "joint ventures" with Guangdong firms to get access to liberal foreign exchange retention policies.

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Guangdong authorities will also have to contend with growing trade restrictions by neighboring provinces. Officials in Beijing and the poorer provinces that border Guangdong maintain that Guangdong's reforms have succeeded at the expense of its neighbors. Resentful of shortages in their own provinces, Hunan and Jiangxi recently restricted sales of such products as pork and grain to Guangdong, and have levied heavy fines on illegal exporters. Precise estimates of the potential damage to Guangdong from such embargoes are impossible, but Guangzhou officials have noted that city markets receive between a third and a half of their pork supply from outside the province. Further decontrol of industrial and consumer goods prices in Guangdong, and the price rises certain to follow, could, in our view, invite further reprisals against Guangdong.

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"The Great War of Live Pigs"

Guangdong has recently faced political attacks from other provinces envious of its success. The 1985 decontrol of pork prices in Guangdong, for example, drove market prices in Guangdong far above those permitted in Hunan. In early 1987, "floods" of profit-seeking Hunan farmers drove their hogs to Guangdong for sale, touching off what People's Daily called the "Great War of Live Pigs" between the two provinces. Faced with declining supplies and rising pork prices at home, the Hunan provincial government "closed the borders" to pork exports, fining farmers 50 yuan per hog if they were caught transporting hogs into Guangdong. In its recent report lauding Guangdong's price reforms, People's Daily approvingly noted that Hunan farmers were undeterred, and continued to sneak out their hogs to more profitable Guangdong markets.

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Looking Ahead

Thus far, Zhao has been relatively successful in silencing high-level critics of Guangdong and the SEZs. Since late December, for example, conservative leaders Peng Zhen, Bo Yibo, and Wang Zhen—who a year ago led the attack on "bourgeois liberalism"—have visited Guangdong and publicly praised its achievements in reform and opening to the outside. Recent removals of conservatives in the party discipline inspection and propaganda sectors—both of which have harassed local reformers in the past—will further weaken reform opponents' ability to interfere in Guangdong. Locally, recent personnel moves have further strengthened Guangdong's reform leadership. The

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15 January election of the flamboyant reformer Lei Yu--purged in 1985 for his lax handling of the Hainan auto resale scandal²--as Guangzhou Vice Mayor will doubtless upset conservatives such as Chen Yun, who pointed to Lei's case as an example of the corruption they argue is inherent in China's "open door" policies. [REDACTED]

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Regarding the impact of the reform package in Guangdong itself, we believe Zhao's local hothouse strategy will be successful. For example, the newly enlarged Pearl River Economic Zone--spurred by Hong Kong subcontracting orders and recently expanded foreign exchange retention rights--will accelerate Guangdong's "opening to the outside." Also, despite recent public complaints about inflation in Guangdong, we expect local authorities to implement further reforms of wages and food prices this year. Finally, Guangdong has made some progress--which we expect will continue--in closing party offices that interfere in government economic work. [REDACTED]

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Assessing the Broader Impact

Guangdong's advantages as a reform proving ground are so unique that we believe many of its new policies can be transplanted to only a few other economically advanced coastal areas in the near to midterm. Wage reform, specifically the introduction of piece-rate wages; and reforms in the foreign investment system designed to cut red tape and improve foreign access to market information are likely to be easiest to implement. The "foreign trade responsibility system"--designed to make exporting firms live within their own budgets--will require politically difficult subsidy cuts for many powerful firms. [REDACTED]

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Implementing price reforms elsewhere, particularly in the interior provinces, will be extremely difficult, as reform leaders readily acknowledge. The fear of inflation and shortages that prompted Hunan and Jiangxi to impose embargoes on the sale of goods to Guangdong--rather than allowing the prices of these goods to rise and become more competitive--illustrates one of the problems reformers face in trying to decontrol prices. [REDACTED]

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Even if the export strategy is modestly successful, it is by no means clear how Zhao envisions Guangdong and the other coastal areas serving as "engines of growth" for China's poorer interior. If Zhao hopes coastal development will spark increased interregional trade, he will have to find more effective ways of breaking down internal trade barriers than Beijing has to date. As the "war of live pigs" illustrates, the leadership of the interior provinces will often forgo the potential benefits of increased

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trade to protect themselves against price fluctuations and shortages of essential goods. Mao's policy of local self-sufficiency taught these officials an array of tricks to control trade in their bailiwicks, including the use of business permits, export fees, and outright embargoes. [REDACTED] 25X1

At present, Beijing has few levers to force greater provincial cooperation, as its inability to control provincial capital construction investment demonstrates. Nevertheless, Beijing is promoting some measures that should encourage greater cooperation without seriously threatening local leaders' ability to limit disruptions caused by greater trade. According to recent statements by a Chinese official, these include:

- Encouraging economic agreements between provinces to promote interregional economic zones and integrated markets. Thus far these agreements have only been partially successful in breaking down local protectionism, but they could lay the groundwork for greater integration.
- Creating cross-regional and cross-industrial conglomerates, free of local government control, to handle trade in raw materials and other goods. [REDACTED] 25X1

[REDACTED] Zhao must be careful to keep the gap between the coast and interior from widening too far, to avoid increasing political and economic friction between these two disparate regions. Zhao probably hopes his export strategy will expand coastal revenues, which he can then use to increase development subsidies for the interior. In the meantime he has sought to reassure interior leaders that their provinces will not be "milked" to supply the coastal provinces with scarce raw materials and development funds for his export strategy. [REDACTED] 25X1

Appendix A

New Initiatives

Guangdong officials have announced new reform initiatives, while others await final approval by the State Council. We believe the final package will include:

- A wage deregulation plan which, according to State reporting, will allow enterprises to set their own rates for employees.
- Allowing Guangdong to keep a much larger share of the foreign exchange that provincial enterprises earn from exports-- 30 percent of the exchange made on sales of state plan products, and 80 percent on sales of non - state plan products.
- Decontrolling grain and edible oil prices this year, and partially decontrolling sugar and sugarcane. In December, Governor Ye told reporters Guangdong may also deregulate timber prices in 1988.
- Extending the special reform policies of the Pearl River Economic Zone to an additional 29 cities and counties. These policies--designed to attract foreign investors--include tax and tariff breaks for export manufacturers, as well as local government autonomy to approve joint ventures.
- Raising the limit on foreign investment projects Guangdong may authorize from \$30 million to \$100 million, according to the PRC-controlled Hong Kong newspapers. The limit had been raised from \$10 million in 1987. Very few potential investment projects are likely to exceed the new limit.
- Authorizing Guangzhou and the Shenzhen Special Economic Zone to experiment with land ownership and sales reforms. In November, Shenzhen held China's first land auction since the early 1950s.
- Allowing Guangdong export firms to deal directly with foreign firms instead of trading through government import-export companies. In return, state subsidies to these export firms will be cut.
- Abolishing government departmental party committees to lessen party interference in government affairs, according to Hong Kong press sources.

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Appendix B

Unique Guangdong in Perspective

Although Guangdong accounts for only 6 percent of China's population (ranked 4th), the province is one of China's most dynamic economically (see graphic). Guangdong is China's number-one exporter, leading number-two - ranked Shanghai by about 30 percent. Guangdong's share of foreign business in China--measured either as direct foreign investment paid in, or in numbers of firms--far exceeds that of all other provinces combined (figure 1). Like China's other fastest growing industrial provinces--such as Zhejiang and Jiangsu--Guangdong has emphasized smaller collectively owned and individually owned enterprises over large, state-owned industries (figure 2). The performance of these smaller firms, which often subcontract labor-intensive manufacturing for Hong Kong and other foreign firms, has been particularly dynamic in the Pearl River Delta region. [REDACTED] [REDACTED] over the last five years, industrial growth rates in this area have roughly doubled the already high national average (figure 3). [REDACTED]

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Figure 1
Guangdong's Economy in Perspective

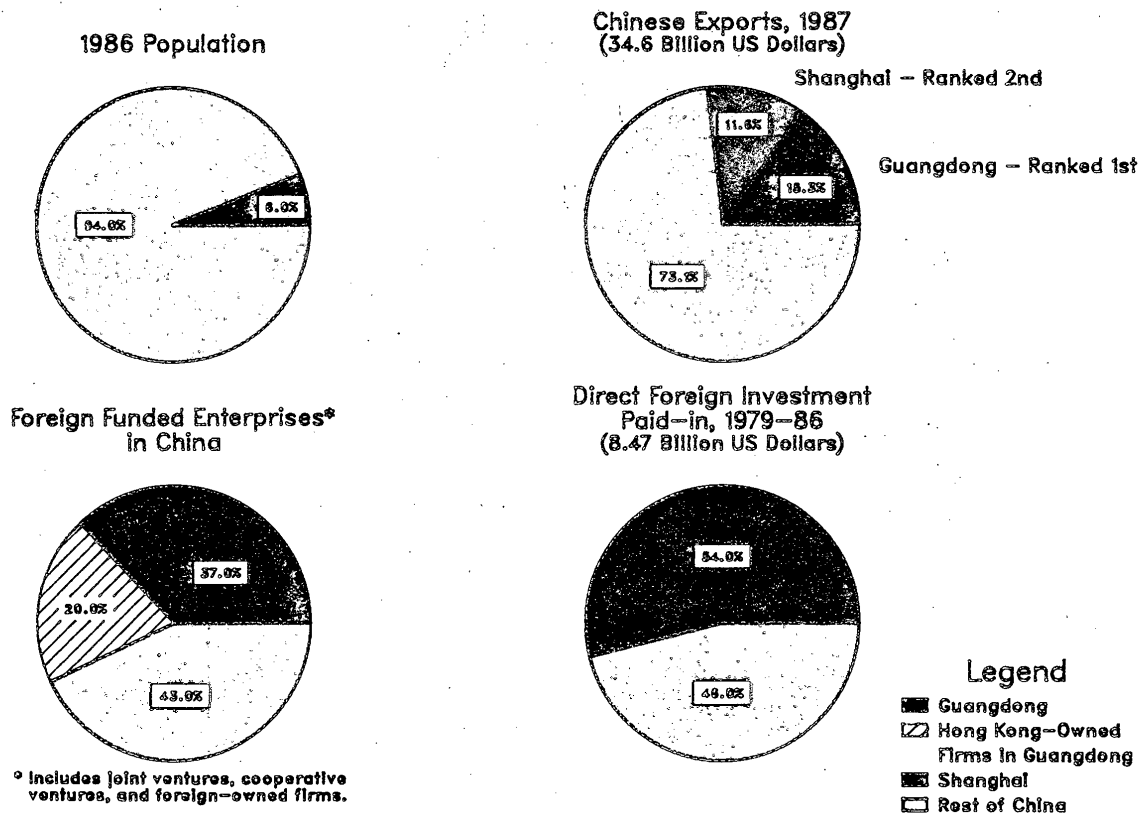
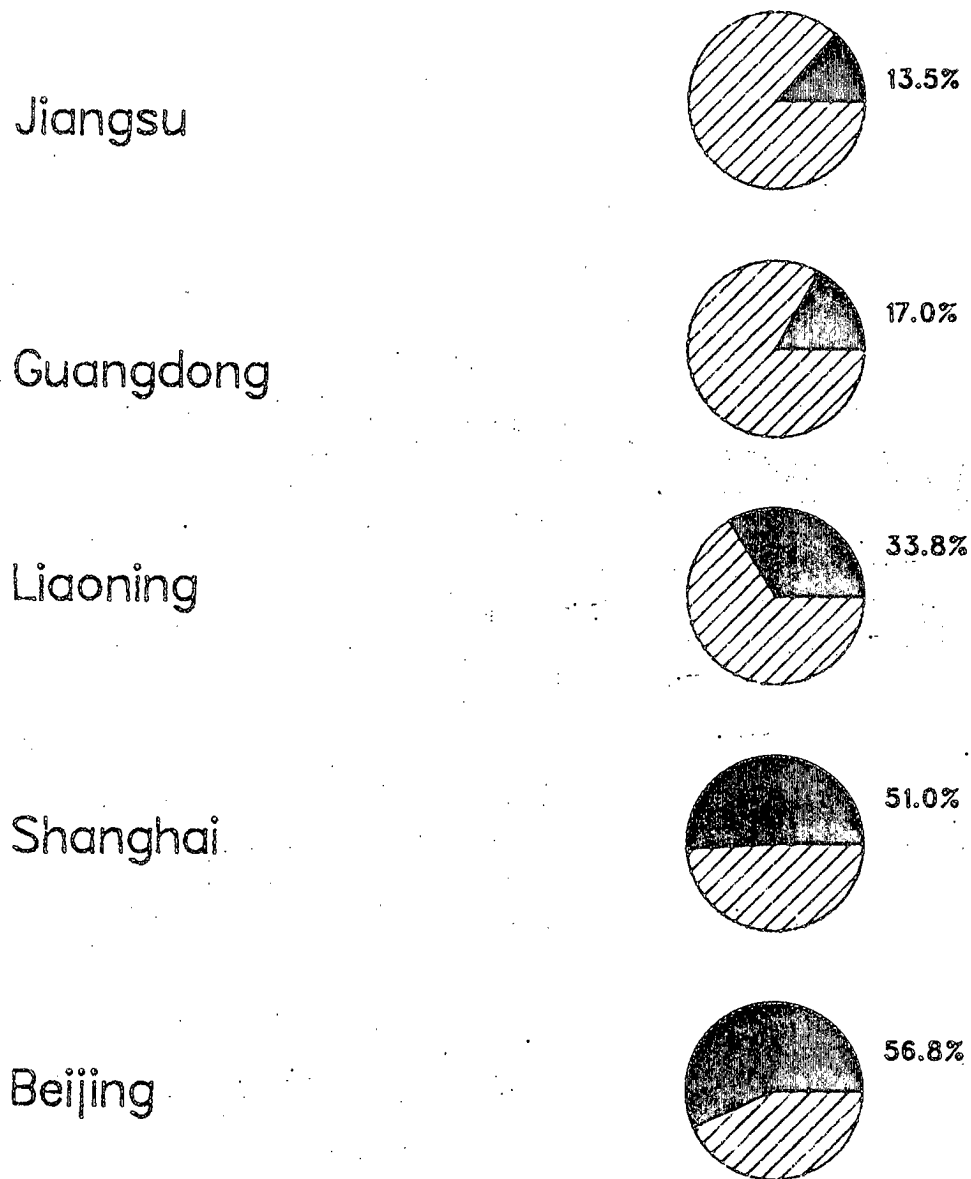


Figure 2
Percent of All Employed Persons
in State-Owned Enterprises

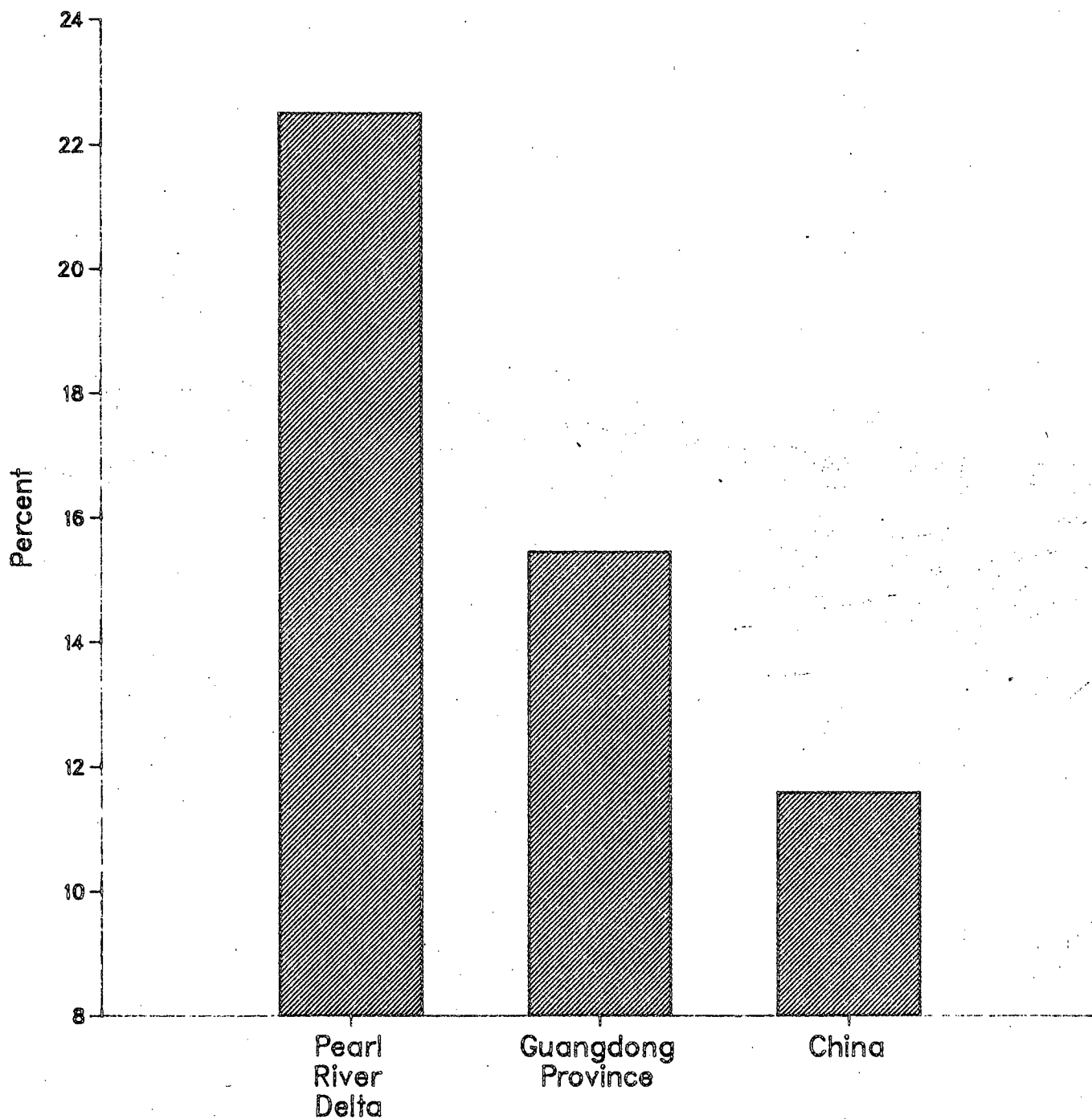


Source: PRC State Statistical Bureau Figures.

Legend
[Hatched Box] State-Owned
[Solid Black Box] Employed Outside
State-Owned Sector

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Figure 3
Industrial Production
Average Annual Growth Rate
1981-86



Source: PRC State Statistical Bureau Figures,
Hong Kong Banking Sources.

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